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TAGS: ECON EFIN PGOV HR
SUBJECT: CROATIAN VOTERS RELUCTANT TO GIVE CREDIT FOR GROWTH TO CURRENT GOVERNMENT

Classified By: Economic Officer Isabella Detwiler reasons 1.5 (b and d)

Summary

¶1. (SBU) Going into the elections this weekend, the current coalition government has a good story to tell -- healthy GDP growth, declining unemployment, progress on its Stabilization and Association Agreement with the EU, new roads, and constructive relationships with the IMF and World Bank. Even on the structural side, the government has made some major advances, such as in pension reform and downsizing of the police and military. The main clouds on the horizon are burgeoning debt, both private and public. Whether the progress was great enough and fast enough for the voters to give the government credit is in doubt. Additionally, the Croatian public appears to share a characteristic with other central and eastern Europeans -- they perceive their situation to be significantly worse than the numbers would indicate. End Summary

Perils of Pauline with the IFIs

¶2. (C) On November 12, the IMF completed a second review of its Stand-by Arrangement with Croatia. While Croatia needed four waivers -- in part because the national oil company privatization receipts came in after the formal end of the review -- the IMF had a hard time arguing with greater-than-planned GDP growth (for the second year in a row), budgetary restraint, and strong foreign reserves. Many observers had anticipated a train wreck on the current account deficit -- this year's big issue -- but, if the figures are to be believed, an enormously successful tourist season saved the Croatian government at the last hour. (This is reminiscent of the situation last year, when the fiscal deficit was the major concern. The government ended up confounding the IMF and most observers by outperforming that target as well by an almost inexplicable under-execution of the budget.)

¶3. (SBU) Another rabbit-out-of a-hat moment came when the government managed to pass a package of laws and amendments to fulfill conditions for the second tranche of its World Bank Structural Adjustment Loan. The World Bank showed repeated flexibility, including delaying the "drop-dead" deadline of the review. This approach paid off, since the government secured reforms to the labor laws considered impossible by many -- albeit while alienating its allies in the labor unions in the process. The parliament also passed legislation on bankruptcy, budget preparation, corporate governance and competition. Between these achievements and the laws the government has scrambled to pass to fulfill requirements of the EU, Croatia has made great progress on its legislative framework. Implementation and enforcement will continue to be sticking points.

Despite Everything, Quite a bit of Success

¶4. (C) This phenomenon -- outperforming economically almost despite itself -- has been characteristic of this government. Despite a woeful lack of economic talent, especially at the Ministries of Finance and Economy, the economy is on an upward, if shaky, path. Much of the credit goes to prudent management at the Central Bank and lack of alternative investment opportunities in Western Europe, but also the prudent decisions of the previous and current governments to privatize the banking sector, most of the national telecommunications company, and a large chunk of the oil company, as well as the decision of this government to pursue restrictive agreements with the IMF and World Bank. The efforts of numerous small and medium-sized entrepreneurs, while hard to quantify, appear to be playing an increasingly important part in the economic recovery.

¶5. (SBU) The banking crisis of the late Tudjman regime and the resultant recession forced the Socialist (SDP)-led government to move ahead on reforms that it might otherwise have avoided. Whatever the motivation, the government can point to the strongest GDP growth in the region -- 5.2 percent last year, 3.8 percent in 2001, and 3.9 percent in the first year of its mandate, 2000. Projections for this year range from a low of 3.5 percent up to five percent --

with the final result likely to be closer to the higher number. Inflation has been lower even than expected, less than two percent this year, and 2.2 percent last year. Foreign Direct Investment has fluctuated with several large deals, but, despite being well below potential, it has put Croatia in the middle of the Central and Eastern European pack in per capita terms. The fiscal deficit remains too high, but decreased from 6.5 and 6.8 percent of GDP in 2000

and 2001 respectively, to 4.8 percent in 2002 and is expected to come in close to the planned 4.6 percent this year. The government has ambitious plans to cut the deficit to 3.8 percent in 2004 -- a goal they have perhaps wisely not made public.

¶6. (U) Unemployment, in many ways the bottom line, has begun to move downwards. After reaching a high of 16.1 percent in 2000 (ILO-survey), it fell to 14.1 for the first half of this year -- still above the 13.6 percent of the HDZ's final year.

¶7. (SBU) Of course, this rapid growth has been accompanied by some economic imbalances, which if not addressed, could lead to or worsen the next recession. Much of this impressive growth was fueled by government investment, principally in roads, and frantic consumer (and business) spending. While industrial production has been increasing steadily, much of this spending is on imports. This led to an eye-popping increase in the current account deficit, from 3.7 percent of GDP in 2001 to 7.2 in 2003. While the IMF had hoped to drive this down to 3.6 in the current year, it had to adjust its goal to 5.9 after the first review of the Standby Arrangement, and even then feared the goal would be missed.

¶8. (C) In a suspiciously dramatic escape, as-yet unpublished data showed that tourism inflows for the first nine months of this year were 89 percent (yes, eighty nine) above last year, thus allowing the GOC to make the revised current account deficit goal. While the IMF is understandably skeptical, it has not been able to poke holes in the numbers. The local IMF rep told us that the best indication that the data, if not actually accurate, at least are not an out-and-out lie, is that the Central Bank also refused to believe the numbers at first, until it found it could not refute them.

Curbing Credit Growth

¶9. (SBU) Perhaps more sustainably, measures that the Central Bank took to slow down the growth of credit and debt have begun to take hold. The annual rate of credit expansion fell from 31.3 percent at the end of 2002 to below 20 percent, and is still falling, much to the distress of the banks and businesses.

¶10. (C) Debt has become the latest target of concern among the financial press and critics of the government, including the Central Bank. Total external debt, both public and private has soared from 59.7 percent of GDP in 2000 to 68.5 percent in 2002. The Central Bank, resisting efforts from the IMF to tighten monetary policy further for fear of being blamed for a recession, has argued that government spending and guarantees to public companies are the main culprits of the expanding debt -- an argument that may be overblown. Public debt increased more moderately from 51.1 percent of GDP in 2000 to 51.6 in 2002. Given the size of the current account deficit, the IMF and others want to squeeze both the increase in imports by slowing credit growth (through monetary policy) and government spending. The government is also being pushed to finance more of its needs on the domestic market. A properly functioning Ministry of Finance would certainly help in this area.

¶11. (C) While the official numbers for public debt do not look overly alarming, the GOC did breach its agreement with the IMF not to issue more guarantees than it retired. Most of the new guarantees were for a railroad improvement project, which in its current, ambitious form, is met with skepticism by both the World Bank and the IMF. The government plans to pay for future hefty investments in railroads with cuts in other spending, including social transfers and subsidies.

Privatization Mixed

¶12. (SBU) On privatization, the picture is also mixed. The state telecommunications company is majority-private, due to a process started by the previous government. The current government pushed though a very successful sale of 25 percent plus one share of the state oil company, with a further 15 percent to be privatized next year. As mentioned earlier, the banking sector is largely in foreign, private hands. The government is scaling back and pushing back the sale of parts of the state electricity company, specifying that now only

distribution will be privatized. The sale of the state insurance company can be considered a failure, as the GOC negotiates with the Catholic Church to take 25 percent of the company as compensation for post-WWII expropriations, and proposes the sale of an additional 20 percent through the stock exchange. However, private insurance companies continue to expand their market share.

¶13. (C) The Croatian Privatization Fund handles the large state portfolio of smaller properties, mainly tourist and industrial properties. After a politically motivated brouhaha over the sale of a resort complex on the island of Hvar early this year, no sales of companies have been finalized. However, tender preparations continue, 35 entities were tendered, and contracts are being negotiated for 12 of these. Also in the past year, the government divested itself of minority shares in various companies valued at approximately $40 million. While both the right and the left are shying away from discussing privatization during the campaign, both the right-of-center HDZ and left-of-center SDP seem to recognize the necessity of off-loading money losing enterprises. However, the Croatian Peasant's Party, which brought the current privatization process to a near halt and whose support is very likely needed to form the next coalition, takes the most stridently anti-privatization line and could continue to play an obstructionist role in the next government.

No Respect

¶14. (SBU) Despite the government's significant successes, and despite porky "goodies" such as roads and subsidies to struggling industries, most notably in the shipbuilding and ship repair industries, the public appears unappreciative. While rates of poverty are relatively low -- 5 to 10 percent depending on the measure, in line with Slovenia and the Czech Republic -- over half the public, according to one poll, say they are barely making ends meet and need to take out loans. Another poll shows that, despite evidence to the contrary, 58 percent of respondents thought that unemployment was increasing. 32 percent thought economic growth was negative, and 37 percent thought it was unchanged. A dismal 51 percent thought their living standards had deteriorated since the ruling coalition came to power, only 14 percent thought living standards had improved.

¶15. (C) While this exaggerated pessimism appears to be a characteristic of the region, it may be magnified in Croatia because of the fractious nature of the coalition, the legacies of the war, and discrepancies in growth between Zagreb and the coast on one hand, and the rest of the country on the other. It is a distinct possibility that this pessimism will translate into a vote against the current government, in order to punish it for sins real and imagined.
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